

AMENDED IN SENATE MAY 17, 2005

SENATE BILL

No. 663

Introduced by Senator Migden
(Coauthor: Senator Machado)

February 22, 2005

An act to ~~amend Section 25110 of~~ *amend and add Section 25110 of* the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

SB 663, as amended, Migden. Corporation taxes: water's-edge election: foreign affiliated corporations.

Existing law provides that, in the case of a business with income derived from or attributable to sources both within and without this state, the income is apportioned between this state and the other states and foreign countries for tax purposes in accordance with a specified formula based on the property, payroll, and sales within and without this state. Existing law permits a qualified taxpayer, as defined, to elect to determine its income under a water's-edge election. A water's-edge election provides that only the income and apportionment factors of certain described affiliated corporations may be included for purposes of determining the taxpayer's income apportioned to this state.

Existing law requires that income and apportionment factors of a foreign corporation be included in the combined report of a taxpayer making a water's-edge election, but only to the extent of the foreign corporation's United States-source income and apportionment factors. The income and apportionment factors of a controlled foreign corporation, as defined in the Internal Revenue Code, that is an affiliated corporation of a taxpayer are included in the combined report of the taxpayer making a water's-edge election to the extent of

the “Subpart F” income ratio, as determined under existing law. Existing law, however, does not specify whether the United States-source income rules or the rules regarding “Subpart F” income, as defined in the Internal Revenue Code, apply to income of a controlled foreign corporation that has both United States-source income and “Subpart F” income.

This bill would clarify that existing law prohibits a controlled foreign corporation from excluding its “Subpart F” income from a water’s-edge combined report, even if it is a California taxpayer or has income from a United States source. This bill would also clarify that existing law requires inclusion in a water’s-edge combined report of both United States-source income and Subpart F income of a controlled foreign corporation, regardless of whether the corporation is a California taxpayer. This bill would declare *the intent of the Legislature* that this clarification ~~is~~ *be* operative for taxable years beginning on or after January 1, ~~2005~~ 2006. This bill would require the Franchise Tax Board to promulgate regulations to prevent the potential double taxation of income when a controlled foreign corporation has both United States-source income and “Subpart F income.”

Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

The people of the State of California do enact as follows:

- 1 SECTION 1. Section 25110 of the Revenue and Taxation
- 2 Code, as amended by Section 58 of Chapter 182 of the Statutes of
- 3 2004, is amended to read:
- 4 25110. (a) Notwithstanding Section 25101, a qualified
- 5 taxpayer, as defined in paragraph (2) of subdivision (b), that is
- 6 subject to the tax imposed under this part, may elect to determine
- 7 its income derived from or attributable to sources within this
- 8 state pursuant to a water’s-edge election in accordance with the
- 9 provisions of this part, as modified by this article. A taxpayer,
- 10 that ~~makes~~ *made* a water’s-edge election *prior to January 1,*
- 11 2006, shall take into account the income and apportionment
- 12 factors of the following affiliated entities only:
- 13 (1) Domestic international sales corporations, as described in
- 14 Sections 991 to 994, inclusive, of the Internal Revenue Code and

1 foreign sales corporations as described in Sections 921 to 927,
2 inclusive, of the Internal Revenue Code.

3 (2) Any corporation (other than a bank), regardless of the
4 place where it is incorporated if the average of its property,
5 payroll, and sales factors within the United States is 20 percent or
6 more.

7 (3) Corporations that are incorporated in the United States,
8 excluding corporations making an election pursuant to Sections
9 931 to 936, inclusive, of the Internal Revenue Code, of which
10 more than 50 percent of their voting stock is owned or controlled
11 directly or indirectly by the same interests.

12 (4) A corporation that is not described in paragraphs (1) to (3),
13 inclusive, or paragraph (5), but only to the extent of its income
14 derived from or attributable to sources within the United States
15 and its factors assignable to a location within the United States in
16 accordance with paragraph (3) of subdivision (b). Income of that
17 corporation derived from or attributable to sources within the
18 United States as determined by federal income tax laws shall be
19 limited to and determined from the books of account maintained
20 by the corporation with respect to its activities conducted within
21 the United States.

22 (5) Export trade corporations, as described in Sections 970 to
23 972, inclusive, of the Internal Revenue Code.

24 (6) Any affiliated corporation which is a “controlled foreign
25 corporation,” as defined in Section 957 of the Internal Revenue
26 Code, if all or part of the income of that affiliate is defined in
27 Section 952 of Subpart F of the Internal Revenue Code (“Subpart
28 F income”). The income and apportionment factors of any
29 affiliate to be included under this paragraph shall be determined
30 by multiplying the income and apportionment factors of that
31 affiliate without application of this paragraph by a fraction (not
32 to exceed one), the numerator of which is the “Subpart F
33 income” of that corporation for that taxable year and the
34 denominator of which is the “earnings and profits” of that
35 corporation for that taxable year, as defined in Section 964 of the
36 Internal Revenue Code.

37 (7) (A) The income and factors of the above-enumerated
38 corporations shall be taken into account only if the income and
39 factors would have been taken into account under Section 25101
40 if this section had not been enacted.

1 (B) The income and factors of a corporation that is not
2 described in paragraphs (1) to (3), inclusive, and paragraph (5)
3 and that is an electing taxpayer under this subdivision shall be
4 taken into account in determining its income only to the extent
5 set forth in paragraph (4).

6 (b) For purposes of this article and Section 24411 *all of the*
7 *following definitions apply:*

8 (1) An “affiliated corporation” means a corporation that is a
9 member of a commonly controlled group as defined in Section
10 25105.

11 (2) A “qualified taxpayer” means a corporation which does
12 both of the following:

13 (A) Files with the state tax return on which the water’s-edge
14 election is made a consent to the taking of depositions at the time
15 and place most reasonably convenient to all parties from key
16 domestic corporate individuals and to the acceptance of
17 subpoenas duces tecum requiring reasonable production of
18 documents to the Franchise Tax Board as provided in Section
19 19504 or by the State Board of Equalization as provided in Title
20 18, California Code of Regulations, Section 5005, or by the
21 courts of this state as provided in Chapter 2 (commencing with
22 Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing
23 with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil
24 Procedure. The consent relates to issues of jurisdiction and
25 service and does not waive any defenses a taxpayer may
26 otherwise have. The consent shall remain in effect so long as the
27 water’s-edge election is in effect and shall be limited to
28 providing that information necessary to review or to adjust
29 income or deductions in a manner authorized under Sections 482,
30 861, Subpart F of Part III of Subchapter N, or similar provisions
31 of the Internal Revenue Code, together with the regulations
32 adopted pursuant to those provisions, and for the conduct of an
33 investigation with respect to any unitary business in which the
34 taxpayer may be involved.

35 (B) Agrees that for purposes of this article, dividends received
36 by any corporation whose income and apportionment factors are
37 taken into account pursuant to subdivision (a) from either of the
38 following are functionally related dividends and shall be
39 presumed to be business income:

1 (i) A corporation of which more than 50 percent of the voting
2 stock is owned, directly or indirectly, by members of the unitary
3 group and which is engaged in the same general line of business.

4 (ii) Any corporation that is either a significant source of
5 supply for the unitary business or a significant purchaser of the
6 output of the unitary business, or that sells a significant part of its
7 output or obtains a significant part of its raw materials or input
8 from the unitary business. “Significant,” as used in this
9 subparagraph, means an amount of 15 percent or more of either
10 input or output.

11 All other dividends shall be classified as business or
12 nonbusiness income without regard to this subparagraph.

13 (3) The definitions and locations of property, payroll, and
14 sales shall be determined under the laws and regulations that set
15 forth the apportionment formulas used by the individual states to
16 assign net income subject to taxes on or measured by net income
17 in that state. If a state does not impose a tax on or measured by
18 net income or does not have laws or regulations with respect to
19 the assignment of property, payroll, and sales, the laws and
20 regulations provided in Article 2 (commencing with Section
21 25120) shall apply.

22 Sales shall be considered to be made to a state only if the
23 corporation making the sale may otherwise be subject to a tax on
24 or measured by net income under the Constitution or laws of the
25 United States, and shall not include sales made to a corporation
26 whose income and apportionment factors are taken into account
27 pursuant to subdivision (a) in determining the amount of income
28 of the taxpayer derived from or attributable to sources within this
29 state.

30 (4) “The United States” means the 50 states of the United
31 States and the District of Columbia.

32 (c) All references in this part to income determined pursuant to
33 Section 25101 shall also mean income determined pursuant to
34 this section.

35 (d) *This section shall only apply to elections before January 1,*
36 *2006.*

37 *SEC. 2. Section 25110 is added to the Revenue and Taxation*
38 *Code, to read:*

39 *25110. (a) Notwithstanding Section 25101, a qualified*
40 *taxpayer, as defined in paragraph (2) of subdivision (b), that is*

1 *subject to the tax imposed under this part, may elect to determine*
2 *its income derived from or attributable to sources within this*
3 *state pursuant to a water's-edge election in accordance with the*
4 *provisions of this part, as modified by this article. A taxpayer,*
5 *that makes a water's-edge election on or after January 1, 2006,*
6 *shall take into account that portion of its own income and*
7 *apportionment factors and the income and apportionment factors*
8 *of its affiliated entities to the extent provided below:*

9 *(1) The entire income and apportionment factors of any of the*
10 *following corporations:*

11 *(A) Domestic international sales corporations, as described in*
12 *Sections 991 to 994, inclusive, of the Internal Revenue Code and*
13 *foreign sales corporations as described in Sections 921 to 927,*
14 *inclusive, of the Internal Revenue Code.*

15 *(B) Any corporation (other than a bank), regardless of the*
16 *place where it is incorporated if the average of its property,*
17 *payroll, and sales factors within the United States is 20 percent*
18 *or more.*

19 *(C) Corporations that are incorporated in the United States,*
20 *excluding corporations making an election pursuant to Sections*
21 *931 to 936, inclusive, of the Internal Revenue Code.*

22 *(D) Export trade corporations, as described in Sections 970 to*
23 *972, inclusive, of the Internal Revenue Code.*

24 *(2) (A) With respect to a corporation that is not described in*
25 *subparagraphs (A), (B), (C), and (D) of paragraph (1), as*
26 *provided in either one or both of the following clauses:*

27 *(i) The income and apportionment factors of that corporation*
28 *to the extent of its income derived from or attributable to sources*
29 *within the United States and its factors assignable to a location*
30 *within the United States in accordance with paragraph (3) of*
31 *subdivision (b). Income of that corporation derived from or*
32 *attributable to sources within the United States as determined by*
33 *federal income tax laws shall be limited to, and determined from,*
34 *the books of account maintained by the corporation with respect*
35 *to its activities conducted within the United States.*

36 *(ii) The income and apportionment factors of that corporation*
37 *that is a "controlled foreign corporation," as defined in Section*
38 *957 of the Internal Revenue Code, to the extent determined by*
39 *multiplying the income and apportionment factors of that*
40 *corporation without application of this subparagraph by a*

1 *fraction not to exceed one, the numerator of which is the*
2 *“Subpart F income” of that corporation for that taxable year*
3 *and the denominator of which is the “earnings and profits” of*
4 *that corporation for that taxable year.*

5 *(B) For purposes of this paragraph, both of the following*
6 *apply:*

7 *(i) “Subpart F income” means “Subpart F income” as defined*
8 *in Section 952 of the Internal Revenue Code.*

9 *(ii) “Earnings and profits” means “earnings and profits” as*
10 *described in Section 964 of the Internal Revenue Code.*

11 *(3) The income and apportionment factors of the corporations*
12 *described in this subdivision shall be taken into account only to*
13 *the extent that they would have been taken into account had no*
14 *election under this section been made.*

15 *(4) The Franchise Tax Board shall prescribe regulations to*
16 *coordinate implementation of subparagraph (A) of paragraph (2)*
17 *to prevent multiple inclusion or exclusion of income and factors*
18 *in situations where the same item of income is described in both*
19 *clauses.*

20 *(b) For purposes of this article and Section 24411, all of the*
21 *following definitions apply:*

22 *(1) An “affiliated corporation” means a corporation that is a*
23 *member of a commonly controlled group as defined in Section*
24 *25105.*

25 *(2) A “qualified taxpayer” means a corporation that does both*
26 *of the following:*

27 *(A) Files with the state tax return, on which the water’s-edge*
28 *election is made, a consent to the taking of depositions, at the*
29 *time and place most reasonably convenient to all parties, from*
30 *key domestic corporate individuals and to the acceptance of*
31 *subpoenas duces tecum requiring reasonable production of*
32 *documents to the Franchise Tax Board, as provided in Section*
33 *19504, or by the State Board of Equalization, as provided in*
34 *Section 5005 of Title 18 of the California Code of Regulations, or*
35 *by the courts of this state, as provided in Chapter 2 (commencing*
36 *with Section 1985) of Title 3 of Part 4 of, and Chapter 9*
37 *(commencing with Section 2025.010) of Title 4 of Part 4 of, the*
38 *Code of Civil Procedure. The consent relates to issues of*
39 *jurisdiction and service and does not waive any defenses that a*
40 *taxpayer may otherwise have. The consent shall remain in effect*

1 as long as the water's-edge election is in effect, and shall be
2 limited to providing that information necessary to review or
3 adjust income or deductions in a manner authorized by Section
4 482, 861, Subpart F of Part III of Subchapter N, or similar
5 provisions, of the Internal Revenue Code, together with the
6 regulations adopted pursuant to those provisions, and for the
7 conduct of an investigation with respect to any unitary business
8 in which the taxpayer may be involved.

9 (B) Agrees that, for purposes of this article, dividends received
10 by any corporation whose income and apportionment factors are
11 taken into account pursuant to subdivision (a) from either of the
12 following are functionally related dividends and shall be
13 presumed to be business income:

14 (i) A corporation of which more than 50 percent of the voting
15 stock is owned, directly or indirectly, by members of the unitary
16 group and which is engaged in the same general line of business.

17 (ii) Any corporation that is either a significant source of
18 supply for the unitary business or a significant purchaser of the
19 output of the unitary business, or that sells a significant part of
20 its output or obtains a significant part of its raw materials or
21 input from the unitary business. "Significant," as used in this
22 subparagraph, means an amount of 15 percent or more of either
23 input or output.

24 All other dividends shall be classified as business or
25 nonbusiness income without regard to this subparagraph.

26 (3) The definitions and locations of property, payroll, and
27 sales shall be determined under the laws and regulations that set
28 forth the apportionment formulas used by the individual states to
29 assign net income subject to taxes on, or measured by, net
30 income in that state. If a state does not impose a tax on, or
31 measured by, net income or does not have laws or regulations
32 with respect to the assignment of property, payroll, and sales, the
33 laws and regulations provided in Article 2 (commencing with
34 Section 25120) shall apply.

35 Sales shall be considered to be made to a state only if the
36 corporation making the sale may otherwise be subject to a tax
37 on, or measured by, net income under the Constitution or laws of
38 the United States, and shall not include sales made to a
39 corporation whose income and apportionment factors are taken
40 into account pursuant to subdivision (a) in determining the

1 amount of income of the taxpayer derived from or attributable to
2 sources within this state.

3 (4) "The United States" means the 50 states of the United
4 States and the District of Columbia.

5 (c) All references in this part to income determined pursuant
6 to Section 25101 shall also mean income determined pursuant to
7 this section.

8 SEC. 3. (a) Section 25110 of the Revenue and Taxation
9 Code, as added by this act, shall apply to taxable years
10 beginning on or after January 1, 2006.

11 (b) It is the intent of the Legislature that Section 25110 of the
12 Revenue and Taxation Code, as added by this act, apply only to a
13 taxpayer that is required to file on a water's-edge basis in its
14 first taxable year beginning on or after January 1, 2006,
15 pursuant to a water's-edge election in accordance with the
16 provisions of Part 11 (commencing with Section 23001) of
17 Division 2 of the Revenue and Taxation Code, as modified by
18 Article 1.5 (commencing with Section 25110) of Chapter 17 of
19 that part, made on or after January 1, 2006.

20 (c) It is also the intent of the Legislature that, in connection
21 with any matter governed by Section 25110 of the Revenue and
22 Taxation Code, as added by this act, no inference be drawn with
23 respect to any water's-edge election made by a taxpayer prior to
24 January 1, 2006.

25 ~~SECTION 1. Section 25110 of the Revenue and Taxation~~
26 ~~Code, as amended by Section 58 of Chapter 182 of the Statutes~~
27 ~~of 2004, is amended to read:~~

28 ~~25110. (a) Notwithstanding Section 25101, a qualified~~
29 ~~taxpayer, as defined in paragraph (2) of subdivision (b), that is~~
30 ~~subject to the tax imposed under this part, may elect to determine~~
31 ~~its income derived from or attributable to sources within this~~
32 ~~state pursuant to a water's-edge election in accordance with the~~
33 ~~provisions of this part, as modified by this article. A taxpayer that~~
34 ~~makes a water's-edge election shall take into account that portion~~
35 ~~of its own income and apportionment factors and the income and~~
36 ~~apportionment factors of its affiliated entities to the extent~~
37 ~~provided below:~~

38 ~~(1) The entire income and apportionment factors of any of the~~
39 ~~following corporations:~~

1 ~~(A) Domestic international sales corporations, as described in~~
2 ~~Sections 991 to 994, inclusive, of the Internal Revenue Code and~~
3 ~~foreign sales corporations as described in Sections 921 to 927,~~
4 ~~inclusive, of the Internal Revenue Code.~~

5 ~~(B) Any corporation (other than a bank), regardless of the~~
6 ~~place where it is incorporated if the average of its property,~~
7 ~~payroll, and sales factors within the United States is 20 percent or~~
8 ~~more.~~

9 ~~(C) Corporations that are incorporated in the United States,~~
10 ~~excluding corporations making an election pursuant to Sections~~
11 ~~931 to 936, inclusive, of the Internal Revenue Code.~~

12 ~~(D) Export trade corporations, as described in Sections 970 to~~
13 ~~972, inclusive, of the Internal Revenue Code.~~

14 ~~(2) (A) With respect to a corporation that is not described in~~
15 ~~subparagraphs (A), (B), (C), (D) of paragraph (1), as provided in~~
16 ~~either one or both of the following clauses:~~

17 ~~(i) The income and apportionment factors of that corporation~~
18 ~~to the extent of its income derived from or attributable to sources~~
19 ~~within the United States and its factors assignable to a location~~
20 ~~within the United States in accordance with paragraph (3) of~~
21 ~~subdivision (b). Income of that corporation derived from or~~
22 ~~attributable to sources within the United States as determined by~~
23 ~~federal income tax laws shall be limited to and determined from~~
24 ~~the books of account maintained by the corporation with respect~~
25 ~~to its activities conducted within the United States.~~

26 ~~(ii) The income and apportionment factors of that corporation~~
27 ~~that is a “controlled foreign corporation,” as defined in Section~~
28 ~~957 of the Internal Revenue Code, to the extent determined by~~
29 ~~multiplying the income and apportionment factors of that~~
30 ~~corporation without application of this subparagraph by a~~
31 ~~fraction (not to exceed one), the numerator of which is the~~
32 ~~“Subpart F income” of that corporation for that taxable year and~~
33 ~~the denominator of which is the “earnings and profits” of that~~
34 ~~corporation for that taxable year.~~

35 ~~(B) For purposes of this paragraph:~~

36 ~~(i) “Subpart F income” means “Subpart F income” as defined~~
37 ~~in Section 952 of the Internal Revenue Code.~~

38 ~~(ii) “Earnings and profits” means “earnings and profits” as~~
39 ~~described in Section 964 of the Internal Revenue Code.~~

1 ~~(3) The income and apportionment factors of the corporations~~
2 ~~described in subdivision shall be taken into account only to the~~
3 ~~extent that they would have been taken into account had no~~
4 ~~election been made under if this section.~~

5 ~~(4) The Franchise Tax Board shall prescribe regulations to~~
6 ~~coordinate implementation of subparagraph (A) of paragraph (2)~~
7 ~~to prevent multiple inclusion or exclusion of income and factors~~
8 ~~in situations where the same item of income is described in both~~
9 ~~clauses.~~

10 ~~(b) For purposes of this article and Section 24411:~~

11 ~~(1) An “affiliated corporation” means a corporation that is a~~
12 ~~member of a commonly controlled group as defined in Section~~
13 ~~25105.~~

14 ~~(2) A “qualified taxpayer” means a corporation which does~~
15 ~~both of the following:~~

16 ~~(A) Files with the state tax return on which the water’s-edge~~
17 ~~election is made a consent to the taking of depositions at the time~~
18 ~~and place most reasonably convenient to all parties from key~~
19 ~~domestic corporate individuals and to the acceptance of~~
20 ~~subpoenas duces tecum requiring reasonable production of~~
21 ~~documents to the Franchise Tax Board as provided in Section~~
22 ~~19504 or by the State Board of Equalization as provided in Title~~
23 ~~18, California Code of Regulations, Section 5005, or by the~~
24 ~~courts of this state as provided in Chapter 2 (commencing with~~
25 ~~Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing~~
26 ~~with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil~~
27 ~~Procedure. The consent relates to issues of jurisdiction and~~
28 ~~service and does not waive any defenses a taxpayer may~~
29 ~~otherwise have. The consent shall remain in effect so long as the~~
30 ~~water’s-edge election is in effect and shall be limited to~~
31 ~~providing that information necessary to review or to adjust~~
32 ~~income or deductions in a manner authorized under Sections 482,~~
33 ~~861, Subpart F of Part III of Subchapter N, or similar provisions~~
34 ~~of the Internal Revenue Code, together with the regulations~~
35 ~~adopted pursuant to those provisions, and for the conduct of an~~
36 ~~investigation with respect to any unitary business in which the~~
37 ~~taxpayer may be involved.~~

38 ~~(B) Agrees that for purposes of this article, dividends received~~
39 ~~by any corporation whose income and apportionment factors are~~
40 ~~taken into account pursuant to subdivision (a) from either of the~~

1 following are functionally related dividends and shall be
2 presumed to be business income:

3 (i) A corporation of which more than 50 percent of the voting
4 stock is owned, directly or indirectly, by members of the unitary
5 group and which is engaged in the same general line of business.

6 (ii) Any corporation that is either a significant source of
7 supply for the unitary business or a significant purchaser of the
8 output of the unitary business, or that sells a significant part of its
9 output or obtains a significant part of its raw materials or input
10 from the unitary business. "Significant," as used in this
11 subparagraph, means an amount of 15 percent or more of either
12 input or output.

13 All other dividends shall be classified as business or
14 nonbusiness income without regard to this subparagraph.

15 (3) The definitions and locations of property, payroll, and
16 sales shall be determined under the laws and regulations that set
17 forth the apportionment formulas used by the individual states to
18 assign net income subject to taxes on or measured by net income
19 in that state. If a state does not impose a tax on or measured by
20 net income or does not have laws or regulations with respect to
21 the assignment of property, payroll, and sales, the laws and
22 regulations provided in Article 2 (commencing with Section
23 25120) shall apply.

24 Sales shall be considered to be made to a state only if the
25 corporation making the sale may otherwise be subject to a tax on
26 or measured by net income under the Constitution or laws of the
27 United States, and shall not include sales made to a corporation
28 whose income and apportionment factors are taken into account
29 pursuant to subdivision (a) in determining the amount of income
30 of the taxpayer derived from or attributable to sources within this
31 state.

32 (4) "The United States" means the 50 states of the United
33 States and the District of Columbia.

34 (e) All references in this part to income determined pursuant to
35 Section 25101 shall also mean income determined pursuant to
36 this section.

37 SEC. 2. (a) The amendments made to Section 25110 of the
38 Revenue and Taxation Code by this act shall be applied to
39 taxable years beginning on or after January 1, 2005.

1 ~~(b) It is the intent of the Legislature that no inference be drawn~~
2 ~~in connection with any matter governed by Section 25110 of the~~
3 ~~Revenue and Taxation Code for any taxable year beginning~~
4 ~~before January 1, 2005, with respect to the amendments made to~~
5 ~~Section 25110 of the Revenue and Taxation Code by this act.~~

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